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Henry Varay

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By Henry Varay

A problem of growing importance to accountants under modern business and financial conditions is vested in the setting up of reserves for depreciation from the annual profits of their clients. Every machine now in use will have to be replaced at some time in the future. From some source money will have to be provided in sufficient amount to meet the cost of the machine at that time. And no one may say how much money—how many dollars—will be needed to cover the cost of new equipment twenty to twenty-five years hence.

Most corporations fail to provide sinking funds for such contingencies. The general practice is to invest surplus earnings in marketable securities without earmarking them for specific uses. When the necessity arises to discard machinery on account of depreciation or obsolescence, sufficient securities are sold to cover the bill. These securities are held as a reserve against any future necessity. In other cases, where surplus funds have not been invested in such marketable securities, additional capital must be obtained. Fancy the predicament of the manufacturer in 1932, when he was to replace an important machine owing to wear and tear or obsolescence. He, too, invested surplus funds during the years of lucrative business, but now in 1932 the value of his securities was only 20 per cent. of his cost. How was he to replace the machine?

The accountant is faced with problems of this type. His client consults him to provide or acquire the necessary funds. How is the accountant to advise his client?

Before the query can be answered, the accountant has to face a further apprehension. What about inflation? What will be the buying power of the reserve for depreciation to replace machinery if, when the time comes to replace it, inflation is at our threshold?

It is obvious, from the foregoing, that the old method of laissez faire in the funding of depreciation reserves must be abandoned. The vigilant accountant must think of something new.

Now suppose the accountant advises his client to invest, periodically (monthly, semi-annually or annually), the amounts set aside for depreciation and obsolescence. It goes without saying

that the best results from such a method would be obtained if a definite program were followed—a plan involving not only conservative investment advice, but also a system for making the money work as profitably as the safety of the principal permits. It is possible that neither the accountant nor the client would feel competent to lay out a program including the selection of securities. The advice of specialists could be secured, of course, but something more valuable would be an investment method, ready made, and the machinery for applying it. Is there any such method?

Yes, there is. The investment procedure consists of buying selected equity securities periodically, with the same amounts of money always invested on the periodic dates.

The program is simplicity itself, mere elementary mathematics. Investment organizations found that when an investment campaign was carried on over a lengthy period, the buyer acquired relatively few shares when prices were high and many more shares when prices were low. That was because he always used the same amount of money. Fire-insurance companies have unconsciously followed this method for decades. Thus, $1,000 invested monthly during the period September, 1929, to December, 1934, in stocks composing the Dow-Jones industrial averages, was at an average price of 101.72, although some purchases were made as high as 381.17 in the boom! The same amount of money that bought only three shares at the peak, purchases twenty-three shares in the trough of the market slump. All the way down from the boom peak, the $1,000 a month was paying for more and more shares. When only a slight improvement came along after the worst of the decline, the investor quickly had a profit on all of his purchases, inasmuch as the upturn had its greatest effect upon the many shares bought in the lower reaches of the slump.

Purchases made in 1901 of one share each of the stocks used by Dow-Jones industrial averages produced by 1934 an accretion of 5.2 per cent. compounded annually, plus an annual income of 6 per cent. calculated by the value of the principal at the end of each year. These figures take into consideration the revisions made from time to time by Dow Jones & Co. Furthermore, the declaration of stock dividends, issuance of rights and stock split-ups are also considered. At this juncture, it should be borne in mind that from 1901 to 1934 every conceivable economic disturbance, war prosperity, depressions (a number of them) occurred. To be sure, the period was representative.

There are companies operating funds in which the public participates through periodic investments of equal amounts. While I am not in position to pass upon the merits of investment organizations of this kind, still, they do provide the machinery to carry out a program adaptable to depreciation accounts of corporations.

The method described above offers a significant study to the accountant. Assume that the accountant had advised his client to invest annually (or at other periods) the amount set aside from profits for the addition to the reserve for depreciation. He would find that his client has an appreciation in principal at the end of twenty or twenty-five years, in addition to a satisfactory return on investment. Moreover, the accumulated principal is apt to reflect the current buying power of the dollar. He would have enabled his client to replace machinery at the current buying power. Incidentally, this circumstance also answers the currency inflation problem. Since the sagacious management of the investment fund would have invested preponderantly in equities and moderately in bonds and preferred stocks, it is obvious that, should inflation come, the equities would represent current values in inflated dollars. Hence, the client would then be provided with sufficient dollars to purchase machinery at the prevailing prices at that time.